

STATE OF ILLINOIS
SECRETARY OF STATE
SECURITIES DEPARTMENT

IN THE MATTER OF: MERRILL LYNCH PIERCE FENNER &
SMITH INCORPORATED

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) File No. 0900049
)
)

Notice of Hearing

TO THE RESPONDENT: Merrill Lynch, Pierce, Fenner & Smith
Incorporated
CRD NO. 7691

J. David Montague, Esq.
Bank of America
50 Rockefeller Plaza, 7th Floor
New York, New York 10020

You are hereby notified that pursuant to Section 11.F of the Illinois Securities Law of 1953, [815 ILCS 5/1 et seq.] (the "Act") and 14 Ill. Adm. Code 130, Subpart K, a public hearing will be held at 300 W. Jefferson St., Suite 300A, Springfield, Illinois 62702, on the 15th day of February 2012 at the hour of 10:00 a.m., or as soon thereafter as counsel may be heard, before Jon K. Ellis, or such other duly designated Hearing Officer of the Secretary of State.

Said hearing will be held to determine whether an Order should be entered against Merrill Lynch Pierce Fenner and Smith, Incorporated ("Merrill Lynch") which suspends or revokes its dealer registration, prohibits it from offering or selling securities in the State of Illinois and granting such other relief as may be authorized under the Act including but not limited to imposition of a monetary fine in the maximum amount pursuant to Section 11 of the Act, payable within ten (10) days of the entry of the Order.

1. Respondent, Merrill Lynch, beginning in 1959 and up to the present, is registered as a securities dealer with the Illinois Securities Department.

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2. Respondent, Merrill Lynch, also is a Federally Covered Investment Adviser since 1997 and has made notification filings as such in Illinois.
3. Edward Louis Schainker ("Schainker") was formerly registered in the State of Illinois as a salesperson, beginning in 1983, and as an investment adviser representative, beginning in 1998. Schainker was employed by Merrill Lynch from 1983 until 2009 and is subject to a Temporary Order of Suspension of these registrations by the Secretary of State dated February 24, 2009.
4. Merrill Lynch Life Agency Inc. ("MLLA") is an affiliate of Merrill Lynch and, pursuant to 215 ILCS 5/500-35, is a licensed business entity under the Illinois Insurance Law.
5. The Illinois Funeral Directors Association ("IFDA") acts as a trade representative for the Illinois funeral industry. Currently, IFDA has approximately 750 members statewide. Since 1934, IFDA has been a membership not-for-profit corporation that is managed by a board of directors drawn from and elected by its membership in conjunction with certain officer-employees.
6. Formed in 1976, IFDA Services, Inc. ("IFDA Services") is an Illinois corporation created for the purpose of "providing services for the Illinois Funeral Directors Association and its members." IFDA Services is a wholly-owned subsidiary of IFDA, and until January 2008, the IFDA Executive Director served as its president.
7. Since 1979, IFDA Services has provided pre-need trust services to its members.
8. Illinois regulates the sale of "pre-need" funeral and burial purchases under various statutes and regulations, but primarily the Illinois Funeral or Burial Funds Act (the "Burial Funds Act"), 225 ILCS 45/1 *et seq.*
9. There are two primary, distinct types of pre-need contracts authorized under the Burial Funds Act: "guaranteed" and "non-guaranteed" contracts. Under a guaranteed contract, a funeral home guarantees to

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provide a pre-need purchaser or beneficiary (the "Pre-Need Patron") with the services and/or merchandise selected by the Pre-Need Patron for the amount of money stated in the contract. Thus, at the time of death, the Pre-Need Patron is not required to pay any additional costs for the items guaranteed.

10. For a non-guaranteed contract, the ultimate contract price is determined at the time the services and/or merchandise are needed. Thus, while the non-guaranteed contract also sets forth a specific price list, the amount a Pre-Need Patron ultimately pays is determined at time of death. Any payments made by the non-guaranteed Pre-Need Patron are deemed deposits used toward the purchase price.
11. A pre-need contract may be funded in either of two ways: (i) through an insurance policy or annuity written with respect to the life of the Pre-Need Patron, or (ii) through deposit into a trust account.
12. Under the Burial Funds Act, a Pre-Need Patron may deposit his/her funeral payments into a trust, which must be maintained (1) in a trust account established in a bank, savings & loan association, savings bank, or credit union or "(2) in an account with a trust company authorized to do business in Illinois." 225 ILCS 45/2(a). The funeral director receiving the deposit must furnish to the trustee depository the name of each customer and the amount of payment on each account for which a deposit is being made. These funds must be held in trust by a trustee.
13. IFDA Services created and served as the trustee for three Pre-Need Trusts for the investment of money paid as a deposit for Pre-Need contracts sold by its Funeral Home Director member participants: A taxable trust created in 1979, the IFDA Pre Need Taxable Trust ("Taxable Trust"), a tax exempt or tax-advantaged trust, the IFDA Pre Need Tax Exempt Trust, ("Tax Exempt Trust") created in 1986, and the IFDA Municipal Bond Trust (the "Municipal Trust") created in about 1992.
14. Funeral Homes and/or Funeral Directors entered into IFDA Pre Need Trust Program Member Participation Agreements with IFDA Services naming IFDA Services as the trustee for their Pre-need contracts. Additionally, IFDA Services provided Pre-Need Contract forms for use by IFDA Members or their Funeral Home Director/member

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participants. The forms designated IFDA Services as the trustee.

15. IFDA Services' role as Trustee of the IFDA Pre-Need Trusts essentially had two components: (i) the administration of pre-need contracts and deposits into and payments from the IFDA Pre-Need Trusts and (ii) the management of the IFDA Pre-Need Trusts, including investment of Trust assets and approval of management fees and disbursements.
16. The Burial Funds Act permits a trustee to commingle the deposits in a trust for purposes of its management and investment. Although pre-need deposits were commingled for these purposes, IFDA Services maintained separate record-keeping to account for each Pre-Need Patron's contract, as a separate account. A Funeral Director received an individual account "certificate" at the time it deposited money for a new Pre-Need Contract, which disclosed the principal deposited and the earnings rate that IFDA Services promised to credit toward the certificate for the succeeding year. IFDA Services also prepared the required annual filing for the Illinois Office of Comptroller ("IOC"), which contained information about the principal deposit and credited earnings for each Pre-Need Contract.
17. Between 1971 and 2008, IFDA employed two Executive Directors: Robert Ninker ("Ninker") and Paul Dixon ("Dixon").
18. Ninker was the Executive Director from 1971 through 1998, and in that capacity, served as President of IFDA Services. Between 1983 and 1998, Ninker was Merrill Lynch's primary contact at IFDA concerning the IFDA Pre-Need Trusts.
19. In 1999, Dixon assumed the position of Executive Director, which he held until his dismissal in January 2008. After he became Executive Director, Dixon was Merrill Lynch's primary contact at IFDA concerning the Tax Exempt Trust, including the Trust investments.
20. In late 1985, Ninker approached Schainker about attempting to set up an investment program that would not require IFDA to issue Internal Revenue Service (IRS) Forms 1099 to Pre-Need Patrons. After researching the matter, Schainker recommended the use of key-man life insurance, which allowed a company to

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record favorable after-tax yields through cash value accumulation in a life insurance policy written on the life of a corporate executive. In 1985, Merrill Lynch offered through MLLA a single-premium Variable Life (VL) insurance product underwritten by Monarch Life Insurance ("Monarch") called "Prime Plan."

21. In making the recommendation, Schainker explained that, death benefits paid to the beneficiary of a life insurance policy are free from income taxation. In addition, increases in the cash surrender value of life insurance policies ("inside buildup") are not currently taxable to the policy holder. Thus, under federal tax law and rules, the recognition of income earned inside a life insurance contract is deferred until the surrender of the contract, and is limited to the gain on the contract. If the contract is held until death of the insured, no income tax is payable at all.
22. In the late winter of 1985, Schainker and a Merrill Lynch insurance specialist made a presentation to the IFDA executive board concerning the use of VL Policies for the purpose of tax-advantaged investment. The presentation focused on: the ability of investments to appreciate tax-free within the insurance policies; liquidity, including the ability of the Trust to borrow against the insurance policies, tax-free, to meet cash flow needs; the costs and expenses of the insurance investments, including all relevant management and sales fees; and the ability of the Trust to obtain a tax-free transfer of the insurance proceeds upon the death of the insured.
23. The issue of investment liquidity was raised and discussed at length in the presentation. Schainker related that the insurance policies could not be surrendered without penalty or tax implications, but that the Trust could borrow against the insurance, and gave examples of how this could be done at relatively nominal effective rates.
24. Commencing in 1986, IFDA Services purchased a series of Monarch Prime Plan VL policies in the Tax Exempt Trust, which were written against the lives of various IFDA "key-men," including officers and directors, as well as the lives of certain essential Funeral Directors.
25. Throughout its existence, IFDA Services invested funds for the Tax Exempt Trust predominantly in key-person VL

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Policies. Rather than crediting each Pre-Need Patron's account using the pro rata share of actual income or earnings from these investments, IFDA Services credited Pre-Need accounts in the Tax Exempt Trust with earnings based on "projected," "designated" or "credited" rates of earnings ("Tax Exempt Crediting Rate"). IFDA Services, through its Executive Director and board of directors, determined and set the Tax Exempt Crediting Rate for the Tax Exempt Trust.

26. As of February 24, 2009, Schainker had 263 client households totaling over 1700 brokerage accounts. His clients included funeral director associations in three states, funeral homes, owners of funeral homes and their families, and other individual and corporate clients and not for profit organizations.
27. As of December 31, 2009, the IFDA Pre-Need Trust Program held the funds of over 32,000 Pre-Need Patrons, including those deposited in both the Taxable and Tax Exempt Trust. The Tax Exempt Trust, as of December 31, 2009, had a total asset value of \$128,866,956.47.
28. From 1986 to 1998, Schainker recommended and the Tax Exempt Pre-Need Trust purchased 275 VL Policies issued by 6 insurance companies.
29. As of January 31, 2009, the Tax Exempt Trust owned 307 different policies, from 7 different issuers and had paid \$88,272,900 in premiums over the lifetime of these policies. Merrill Lynch Life Insurance Company ("MLLIC"), which, prior to December 2007, had been affiliated with Merrill Lynch, received \$32,016,116 in premiums over the lifetime of 129 policies issued by it or Monarch. MLLA received approximately \$7,192,081 in gross commissions, a portion of which was credited to Schainker. Pursuant to service agreements between MLLA and Merrill Lynch, MLLA paid to Merrill Lynch various service fees and reimbursed certain expenses in connection with the sale of the VL Policies.
30. Schainker's sales of VL Policies to IFDA Services were done with the knowledge and support of Merrill Lynch and MLLA management.
31. VL Policies are, in part, securities and a dealer recommending VL Policies is required to establish and maintain a system to supervise their sales that is reasonably designed to achieve compliance with

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applicable securities laws and regulations, including regulations relating to the sale of securities.

32. VL Policies are variable in their rate of return based upon the investment performance of sub-accounts which may be invested in mutual funds or mutual fund-like accounts. In the case of the IFDA Pre-Need Trust, the allocation of the subaccounts was determined in accordance with the investment policy established by the IFDA, and which the IFDA Board of Directors reviewed and amended from time-to-time. The nature, type and diversification of these sub-accounts were selected by IFDA Services management based upon recommendations by Schainker and Merrill Lynch.
33. IFDA Services, as Trustee of the IFDA Tax Exempt Pre-Need Trust, purchased variable life insurance contracts on the lives of the Officers, Directors and Board Members of IFDA, IFDA Services and certain funeral home directors/member participants in the IFDA Pre-Need Trust program.
34. The insurance contracts purchased for the IFDA Tax Exempt Pre-Need Trust were purchased as key man insurance. The majority of these policies purchased and owned by the Tax Exempt Trust were on the lives of individual funeral home directors and not on the lives of people who were currently officers, directors, employees or board members of IFDA or IFDA Services.
35. IFDA and IFDA Services identified funeral home directors as prospective insured persons. At the direction of IFDA Services, Schainker sent a letter to some of these funeral home directors on behalf of IFDA Services, seeking their consent to be insured as a key man for IFDA Pre-Need Trust. In return for agreeing to be an insured life, IFDA Services offered that funeral director a \$25,000 life insurance policy funded by IFDA Services.
36. When IFDA requested proposals from other firms to act as the trustee and manage the Trust program in 2008, two firms noted the illiquid nature and potential tax consequences of the current investments in the tax exempt trust in their proposals and one firm conditioned acceptance of its proposal upon the liquidation of the VL Policies held by the Tax Exempt Trust.

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37. Beginning around 1990 and continuing into 2008, Schainker made presentations to at least six other state funeral directors associations in order to solicit these associations to employ an investment program involving the use of VL policies in connection with their pre-need trusts. Schainker prepared Power Point presentations that described the IFDA Pre-Need Tax Exempt Trust and used it as a model. These presentations were made with the knowledge and approval of Schainker's supervisors. As a result of these presentations and other solicitations, two other state funeral directors associations opened accounts with Merrill Lynch and operated pre-need funeral trust programs that invested through VL policies.
38. Schainker also attended IFDA conventions in 2007 and 2008 and sponsored a booth providing information about Merrill Lynch's investment services. His participation at these IFDA conventions was approved by his supervisor. Merrill Lynch paid the costs of the booth rental. Additionally in 2008, Merrill Lynch approved an advertisement in the IFDA 2008 yearbook.
39. Schainker opened accounts for two other state funeral directors associations' pre-need trusts with the knowledge and approval of his Merrill Lynch supervisors. Both have ceased being clients of Merrill Lynch.
40. Schainker recommended to both these clients the creation of a tax exempt trust similar to the tax exempt trust used by IFDA. Schainker sold a total of 131 VL Policies to the other pre-need trusts for total premiums paid of \$18,765,503.
41. Additionally, Schainker also recommended to other institutional investors and individual clients the purchase of VL contracts as an investment strategy in order to accrue earnings on a tax-advantaged basis.
42. Schainker communicated with his supervisors at Merrill Lynch detailing his fee generating production from his activities relating to all three Associations.
43. "Production Credits" or "PC's" represent a measure of production (largely based on revenue generated by Merrill Lynch personnel for the sale or provision of investment or other services), utilized by Merrill

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Lynch in calculating compensation for registered representatives and specialists.

44. Schainker received Production Credits in connection with each sale of a VL insurance contract to the Tax Exempt Trust through MLLA and Merrill Lynch. He also received Production Credits for additional premium payments and longevity payments for the policies remaining in effect.
45. From 1986 through 2010, 36 policies purchased by the IFDA Pre-Need Trust through MLLA paid out upon the death of the insured. A total of \$41,457,045 in death benefits was paid to the IFDA Tax Exempt Trust on these policy claims. Additionally, \$269,376.02 in interest on death benefit claims was earned and paid as well. With respect to at least some of the death benefits, Schainker or other Merrill Lynch employees (at the direction of IFDA Services) requested that two checks be issued from the insurance companies, including MLLIC: one check for death benefit proceeds and a second check for interest paid on the death benefit.
46. Death benefit proceeds generally are not subject to income tax; however, the interest earned on death benefit proceeds after death generally is taxable.
47. At the direction of IFDA Services, only the Death Benefit proceeds were paid to the IFDA Pre-Need Tax Exempt Trust, and the interest checks were paid to IFDA Services and deposited into an IFDA Services account.
48. In 1994, Section 4a(d) of the Burial Funds Act was enacted to require Sellers of pre-need funeral contracts to obtain written approval from Pre-Need Patrons before Pre-Need Trust Funds may be deposited in life insurance policies or tax-deferred annuities pursuant to 225 ILCS 45/2a.
49. None of the funeral directors (who sold the pre-need contracts), IFDA Services, the IFDA Pre-Need Trust, Schainker or anyone else provided notice or obtained the permissions of the Pre-Need Patrons before IFDA Services invested in the VL Policies.
50. The purpose of the Tax Exempt Trust was to invest money from pre-need contracts that would be used for funeral and burial expenses. Fundamentally, there was no economic or actuarial correlation between the life

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expectancies of the insureds in the VL Policies and the Pre-Need Patrons.

51. No actuarial or other financial analyses were conducted at any time by Schainker or anyone else at Merrill Lynch, MLLA or MLLIC prior to 2008 to determine if the purchases of the VL Policies, the continued holding of the VL Policies, and payment of premiums to maintain the VL Policies in force, would meet the cash flow objectives of the Tax Exempt Pre-Need Trust.
52. As early as 2002, the independent auditors engaged by IFDA to audit the IFDA Pre Need Trust reported to the IFDA and IFDA Services a shortfall of \$10,331,252 in the Tax Exempt Trust, between the amounts credited on pre-need contracts and the investment assets of the Tax Exempt Trust.
53. In 2005 and 2006, the IOC conducted an audit of the IFDA Pre-Need Trust as of December 31, 2004. The IOC determined that the total Pre Need trust program was under-funded by \$38,504,845. In that analysis, the IOC determined that the underfunding was caused primarily by the IFDA's setting the Taxable and Tax Exempt Crediting Rates and payment of earnings on Pre-Need Contracts in the IFDA Pre-Need Trust in excess of the actual performance of the Taxable and Tax Exempt Trusts' investments.
54. On or about October 29, 2008, IFDA applied a one-time adjustment to the current principal and/or to the current interest recorded in the records of IFDA for certain Pre-Need Contracts with funds on deposit in the IFDA Tax-Exempt Pre-Need Trust ("Adjustment").
55. Some of the VL Policies recommended by Schainker and purchased by the IFDA Pre-Need Trust were Modified Endowment Contracts ("MECs").
56. MECs are life insurance policies that are funded at a rapid rate and which fail to meet a so-called "7-pay" test. In 1988, Congress adopted the Technical and Miscellaneous Revenue Act ("TAMRA"), which altered the tax treatment on distributions from MEC contracts purchased after June 26, 1988.
57. Although insurance policies that are deemed to be MECs still permit tax-deferred inside buildup and tax-free death benefits, they are limited in their ability to

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make tax-deferred loans. The holding of MECs thus limited the tax-deferred liquidity through loans of the contracts within the Tax Exempt Trust to only those VLs that were not MECs.

58. Schainker was subject to at least three internal reviews by Merrill Lynch personnel, none of which were related to the IFDA or the other funeral directors association. The investment accounts and VL Policies purchased by the pre-need trusts for the state funeral directors associations collectively constituted a major source of Schainker's production at Merrill Lynch. Merrill Lynch's Activity Review Monitoring and Online Reporting ("ARMOR") system and its precursors triggered account reviews of the Merrill Lynch IFDA Pre-Need Trust accounts, but these accounts were not otherwise examined, reviewed or audited during any other internal examination process by Merrill Lynch.
59. Additionally, Schainker's immediate supervisor and compliance supervisor stated that although they were aware that the accounts of these three clients contained over 400 VL Policies, and that Schainker made recommendations for allocations in the sub-accounts as part of a corporate owned life insurance investment strategy, they did not implement any supplementary review or supervisory procedures to ensure that Schainker's recommendations were consistent with the clients' investment objectives.
60. Schainker's recommendations of the initial purchase of insurance contracts, and subsequent recommendations with respect to the allocation of the sub accounts of the VL Policies, continued holding of the VL Policies and payments of premiums on the VL Policies did not meet all of the objectives of the IFDA Pre-Need Trusts or the Trust beneficiaries because:
 - a. No actuarial analysis was done at the time of the initial planning, recommendation and implementation of the Tax Exempt Trust fund and no such analysis was prepared during the existence of the fund until 2007 and only after a regulatory inquiry.
 - b. VL Policies, especially MECs, limited the liquidity of the investments, hampering the Tax Exempt Trust's ability to meet potential

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administrative expenses and demands for burial expenses.

61. That by virtue of the foregoing, Schainker has violated sections 12.A, F, and I of the Illinois Securities Law of 1953 815 ILCS 5/1 ("the Act").
62. That by virtue of the foregoing the Respondent's registration as a Dealer is subject to a suspension or revocation pursuant to Section 8.E.1(e) (i) and (iv) and (m) of the Act.
63. That Section 11.E(4) of the Act provides, inter alia, that if the Secretary of State, after finding that any provision of the Act has been violated, may impose a fine as provided by rule, regulation or order not to exceed \$10,000.00 for each violation of the Act.
64. That by virtue of the foregoing, Merrill Lynch is subject to a fine of up to \$10,000.00 per violation, an order of censure and an order that suspends or revokes its Dealer registration in the State of Illinois.

You are further notified that you are required pursuant to Section 130.1104 of the Rules and Regulations (14 Ill. Adm. Code 130) (the "Rules"), to file an answer to the allegations outlined above or a Special Appearance pursuant to Section 130.1107 of the Rules, or other responsive pleading within thirty days of the receipt of this notice. Your failure to do so within the prescribed time shall be deemed an admission of the allegations contained in the Notice of Hearing and waives your right to a hearing.

Furthermore, you may be represented by legal counsel; may present evidence; may cross-examine witnesses and otherwise participate. A failure to so appear shall constitute default.

Delivery of notice to the designated representative of any Respondent constitutes service upon such Respondents.

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Dated this 30th day of January, 2012.



Jesse White
Jesse White
Secretary of State
State of Illinois

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